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## DIRECTORATE OF INTELLIGENCE

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South Korea: Financial Sector Liberalization

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Summary

South Korea's liberalization of its financial sector is part of a broader effort to open its economy that includes easing regulation of imports and direct foreign investment. Economic policymakers are taking deliberate steps to attract additional capital, technology, and management skills, allow the market to determine interest rates, and expand the use of equity markets. Seoul recognizes that it must use caution to avoid shocking the private sector as banks and businesses are weaned from government-directed, subsidized credit. Even so, foreign bankers in particular will find increased opportunities to provide financial services in trade and foreign exchange transactions. We believe that the domestic economy will be strengthened by a more efficient mobilization of capital, more equitable allocation of credit between large conglomerates and small firms, and a shrinking of the illegal curb market.

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<sup>1</sup>See Appendix for an explanation of the curb market.

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This memorandum was prepared by [ ] Korea Branch, Northeast Asia Division, Office of East Asian Analysis. Comments and queries are welcome and may be addressed to Chief, Korea Branch [ ] Information available as of 20 December 1984 has been incorporated. [ ]

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Seoul, which has been loosening controls on the financial sector since 1982, has accelerated the pace of change in the last year. This activity reflects, we believe, a growing concern with scandals linked to the illegal curb market, renewed pressure from foreign bankers, and protectionist measures being applied abroad against South Korean exports produced with subsidized credit.

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Liberalization efforts vary from one financial market to another as do the prospects for future deregulation, but Seoul has crafted its program to benefit all sectors by:

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- Promoting competition in the financial system.
- Reducing government intervention in the routine management of financial institutions, particularly commercial banks.
- Inducing foreign investment in Korean financial institutions by easing restrictions on joint-ventures and according foreign and domestic banks equal treatment.
- Developing new savings and debt instruments to improve bank liquidity and end corporate dependence on subsidized bank loans.

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#### Controls on Commercial Banks Loosened

Seoul is gradually reducing the Bank of Korea (BOK) direct control over the day-to-day management of the banking sector, relying instead on general guidelines and standards of performance. Under the aegis of the Ministry of Finance (MOF):

- In early 1983, the BOK, the central banking authority and formerly the majority stockholder in South Korea's commercial banks, completed a nine year divestiture program.
- The government has replaced direct credit controls for each bank with indirect measures modelled after those of developed countries, including reserve requirements, rediscount operations, and open market operations.
- The BOK's Office of Bank Supervision and Examination is now concentrating on monitoring the financial performance of individual banks and has stopped its micromanagement of bank personnel, organization, and budgeting.
- The government is phasing out its special financial treatment of specific industries by eliminating preferential interest rates and forced lending (that is, loans dictated by government policy).

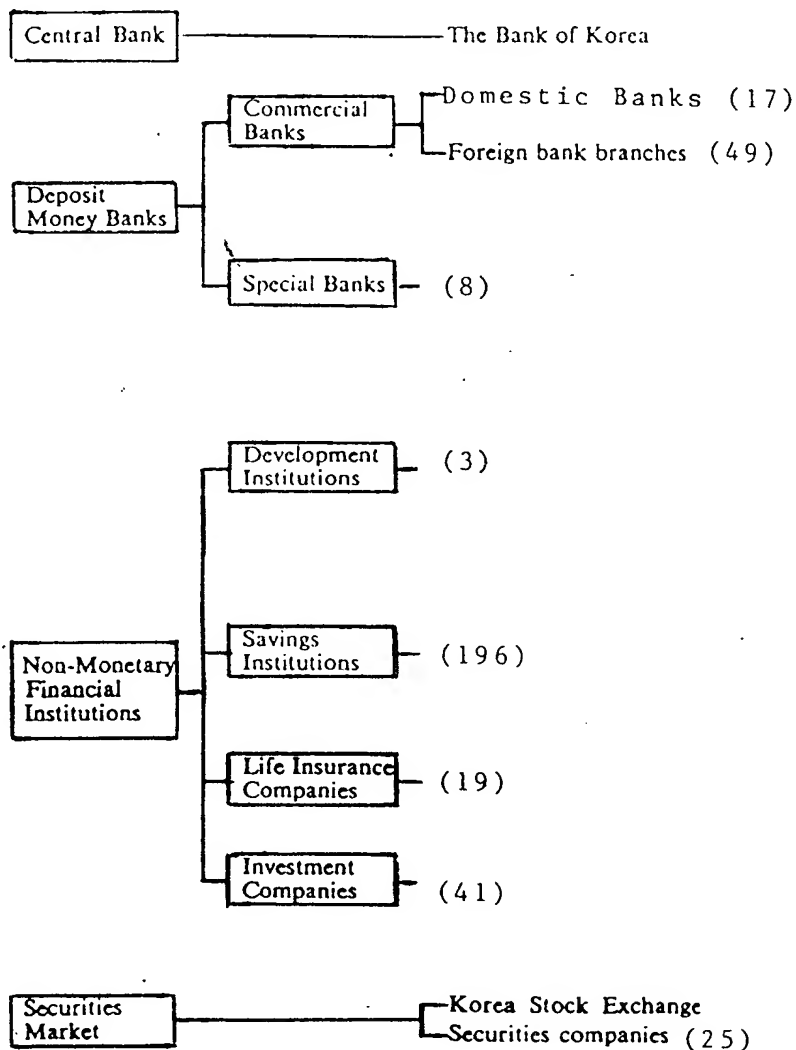
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Figure 1

*The Financial System in Korea*



Note: Figures in parentheses denote the number of institutions.

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Government influence over the financial system remains extensive. The Ministry of Finance, for example, controls interest rates in order to affect inflation and to avert the slower economic growth that might result from higher, market determined interest rates. A major result of this is a continual credit shortage caused by low deposit rates that discourage savings and a strong demand for loans spurred by below market interest rates. In this situation, the absence of market forces requires MOF to control the allocation of credit among sectors: domestic banks must reserve a specified percentage of their loanable funds for small- and medium-sized firms and other high-risk borrowers -- groups bankers would otherwise shun in favor of the largest firms. Foreign banks are not now subject to this requirement but beginning in 1985 foreign banks will also be required to hold similar reserves.

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Seoul also continues to monitor credit flows to the largest firms and to restrict them if they absorb too large a percentage of total credit. MOF took such action against Korea's five largest firms in late 1984. Furthermore, Seoul has decreed that no more than 10 percent of the voting shares in a single bank can be held by individual investors in order to prevent the largest conglomerates from controlling domestic banks.

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We believe these regulations are necessary as a result of the lack of market determined interest rates, the dominance of a few large conglomerates, and the reliance of South Korean firms on cheap debt -- a dependency encouraged by Seoul for almost 20 years to foster industrialization. The MOF's regulatory role also recognizes that the banks and government agencies still do not have experienced personnel who can manage loan portfolios without BOK direction or the trained regulators to conduct adequate bank examinations.

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### Interest Rate Decontrol

The government has taken a few cautious steps to loosen its control over interest rates -- the key to a market-led financial system -- but we believe prospects for a comprehensive decontrol of interest rates soon dim. Prior to 1984, MOF maintained a rigid schedule of loan and deposit interest rates which is now making way for a more flexible system that allows rates to vary within MOF imposed limits. Bankers are now allowed to charge loan rates that reflect the demand for credit and the riskiness of the borrower, although at present even the most creditworthy firms usually pay the highest limit on loan rates because of scarce credit. The complete decontrol in November 1984 of interest rates in the call money market, the rate banks charge other banks for loans, and in the unguaranteed bond market underscore Seoul's commitment to financial sector liberalization.

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Proponents of interest rate liberalization -- located primarily in the Economic Planning Board (EPB) and MOF -- have favored higher market-set rates to attract funds to domestic banks, to maintain the tight money policy considered essential to price control, and to encourage fiscal responsibility in corporate borrowers and bank lenders. Critics of the revisions have cited increased interest costs to business, a potential slowdown in the economy, and a blunting of South Korea's competitive advantage in export markets as disincentives that outweigh the advantages of these reforms.

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Monetary authorities at the MOF have generally preferred to open new types of financial institutions and to introduce new financial instruments that pay higher interest rates rather than to adjust the rates on existing products. In the early 1970s, for instance, they created several nonmonetary financial institutions such as short-term finance companies and mutual savings banks that were allowed to offer higher interest rates. That move was designed to attract curb market resources (Appendix 1) and the new firms were the first authorized to offer such innovations as commercial and industrial paper. Commercial banks can now offer these products, as well as new high-yielding certificates of deposit (CDs).

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Despite the progress made, Seoul has not been responsive to rapidly changing interest rate market signals and continues to set rates in the largest credit markets. Moreover, interest rates for savers, particularly small account holders, are substantially below market levels. As a consequence, the curb market still is more efficient at mobilizing savings than the organized money market. Even so, we believe the freeing of interest rates in important financial markets may accelerate if the experimental call money market and unguaranteed bond rates are not unusually high or volatile.

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#### Foreign Bank Rules Eased

We believe that new regulations placing foreign banks on near-equal footing with domestic banks in the competition for won-denominated deposits and lending to domestic firms will help alleviate criticism from overseas bankers. Nonetheless, a variety of constraints on their role remain in effect, and foreign banks argue that only equal treatment can encourage them to provide new technology and management expertise, as well as to offer the enhanced competition that promotes more efficient banking operations in South Korea. Major areas of foreign bankers' concern have been addressed by changes that put foreign banks on the same footing as domestic banks in the public bond market and allow them to enjoy domestic bank status through joint-ventures with Korean partners. In 1985, the government

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also will give foreign banks access to the BOK rediscount window for preexport financing, followed by provision of full privileges on par with domestic banks by 1986.<sup>2</sup> [redacted] 25X1

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Foreign bankers cite the lack of access to the rediscount window as a key constraint on their effort to expand business to domestic firms. Although their access to the rediscount window will open new business opportunities -- essentially by relieving their chronic shortage of won -- it will also require them to phase out the use of swap transactions<sup>3</sup> as the primary source of won funds for foreign banks. Swap transactions currently protect foreign banks from foreign exchange risks and guarantee profits on funds from home offices -- advantages not available to domestic banks. [redacted] 25X1

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Seoul has not yet addressed the contentious issues of foreign bank capitalization and property ownership. Foreign bankers cannot make large, single-borrower loans, open new branches, and provide high-profit, nonlending services on an equal basis with domestic banks because of regulations that narrowly define their capital -- the basis for their lending limits. Moreover, the prohibition against foreign banks holding title to real estate and other property, including ships and aircraft, denies their use of such collateral to secure loans. [redacted] 25X1

[redacted] 25X1

Although Seoul's attention to several major problem areas will make the investment climate even more attractive to foreign bankers over the next few years, new areas of friction are certain to arise as the financial community's activity expands. Foreign bankers, for example, must still gain MOF approval to enter newly opened markets, a process that is often lengthy because regulations are not clearly spelled out. Moreover, continued depressed profits among domestic banks may prompt Seoul to close the door to new foreign banks. [redacted] 25X1

[redacted] 25X1

<sup>2</sup>Loans to South Korean firms are typically made by discounting commercial bills or promissory notes. The bank gives a business firm a loan equal to the face value of the bill or note less an interest charge. The bank then presents this bill or note to the BOK which rediscounts a portion of its face value at an interest rate that is currently 5 percent. The rediscounted note or bill is a low interest loan to the bank which then can make a new loan with the proceeds at the official loan rate. [redacted] 25X1

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<sup>3</sup>Swap transactions occur when foreign banks acquire currency from their home office (usually in the form of a short-term loan) that is converted into won at the BOK. [redacted] 25X1

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Equity Market Restrictions Relaxed

Seoul has drafted a comprehensive development plan for the securities market to strengthen the Korea Stock Exchange (KSE)<sup>4</sup>. Government officials hope that a sophisticated securities market will provide alternative corporate financing to spur growth and attract foreign equity investment, thus reducing foreign debt. Heretofore, the traditional reliance on subsidized, government-directed loans that are less expensive than equity or bond financing, has retarded the development of securities markets.

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Seoul has opened the KSE to foreign investment in several measured steps. Two \$15 million trust funds of KSE-listed stocks were privately placed with foreign institutional investors in 1981. The Korea Fund, started in 1984 as foreigners' first chance to participate in the Korean securities market, has been well received. Plans are being discussed for a second fund. A limited number of foreign investors will be allowed to purchase shares directly in prescribed industries in 1986. Restrictions on repatriation of profits and on areas where foreign investment is permitted will be lifted in 1988.

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Seoul has encouraged the internationalization of the securities market by allowing, on a reciprocal basis, foreign securities dealers to open representative offices and, since 1983, to establish joint ventures with South Korean securities firms.<sup>5</sup> Korean securities firms overseas, which are strictly controlled by the MOF, can only underwrite bonds of Korean firms, but Seoul plans to lift restrictions on their bond market activities in 1988. Koreans will be free to make investments in foreign securities by the mid-1990s, when liberalization is scheduled to be completed.

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The success of the Korea Fund coupled with the excellent growth prospects for firms listed on the KSE augur well for continued foreign interest in Korean securities. As these markets become more international, the process will provide more capital to spur the domestic growth of South Korean firms and enable them to tap global resources for debt and equity financing.

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<sup>4</sup>The market value of stocks listed on the KSE in 1983 was \$4.5 billion compared with \$450 billion and \$60 billion for Japanese and Australian stock exchanges, respectively.

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<sup>5</sup>Representative offices are authorized to provide only market information services and cannot conduct securities transactions.

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Outlook

Financial sector liberalization will be slow and steady as Seoul attempts to nurture its nascent domestic financial institutions and seeks to attract foreign capital and technology to this sector. We believe, however, that the long-term prospects for movement toward an international, market-based financial system are favorable. The key argument of the liberalizers -- namely that greater reliance on market forces will benefit the Korean economy -- is gaining wider acceptance within the bureaucracy. The current Chun cabinet, for example, is heavily weighted with proponents of liberalization who have eased restrictions on direct foreign investment and imports in addition to opening the financial sector. Nonetheless, the process is certain to move in fits and starts because of bureaucratic tension. Political considerations, economic conditions, and trading partner insistence on reforms could also alter the pace of the liberalization process.

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-- The pace of financial sector liberalization could slacken if policy disputes exacerbate rifts within the ranks of the liberalizers. In January 1984, a proposal by Finance Minister Kim Mahn-je to align interest rates with the market was opposed by Deputy Prime Minister and EPB head Sin Pyong-hyon, delaying reform until November. We believe that the liberalizers will continue to have Chun's ear, but greater caution and his belief that liberalization and the economy are progressing may well curb its pace.

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-- Progress on the reforms also will depend on attitudes among businessmen, politicians, and the general public. Greater reliance on market forces carries a variety of risks and uncertainties, and if economic conditions deteriorate, criticism of government policy would put heavy pressure on Seoul to retake control of the economy.

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-- The 1984 US Trade and Tariff Act is an important impetus for accelerated financial sector liberalization in South Korea. Generalized System of Preferences (GSP) benefits are linked to progress in economic liberalization and South Korean exports to the United States could be sharply curtailed if these benefits were withdrawn. The South Koreans are certain to monitor carefully the US approach to implementation of the trade act's provisions. Meanwhile, Seoul will probably argue for continued access to US markets by highlighting its "developing country" status as well as its unique defense and security needs that demand a prudent economic reform program to maintain stability.

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APPENDIX: The Illegal Money Market in South Korea

[REDACTED] The curb money market, which operates outside the formal financial sector, provides an estimated 10 percent of total domestic credit. Though not illegal in itself, nearly all curb market transactions violate tax laws and are made by unlicensed brokers. The existence of the curb market is explained, in part, by a lack of diversified financial instruments for savers and borrowers and by a rigid system of interest rates that are a constraint in a dynamic economy such as that of South Korea.

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[REDACTED] The curb market is a relatively simple system (figure 2) in which a broker collects savings from households for loans to a third party, usually a business firm looking for short-term credit or, perhaps, to finance a wedding or holiday gift. Savers receive higher than official interest rates with no tax liability and borrowers are willing to pay high loan rates for scarce capital. The official financial sector participates in the curb market as bankers funnel funds between curb market brokers and borrowers.

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[REDACTED] South Korea's curb market is periodically rocked by scandals that paralyze this important source of short-term financing for primarily small- and medium-sized industries. The illegal and unregulated nature of the curb market requires a high reliance on trust in the broker by savers and borrowers. A 1982 scandal resulted from a loss of confidence in a major curb market broker who blatantly displayed government connections, whereas a 1983 scandal was caused by the bankruptcy of a major curb market borrower. These scandals have had only temporary effects on the curb market which rebounds with renewed vigor once order is restored.

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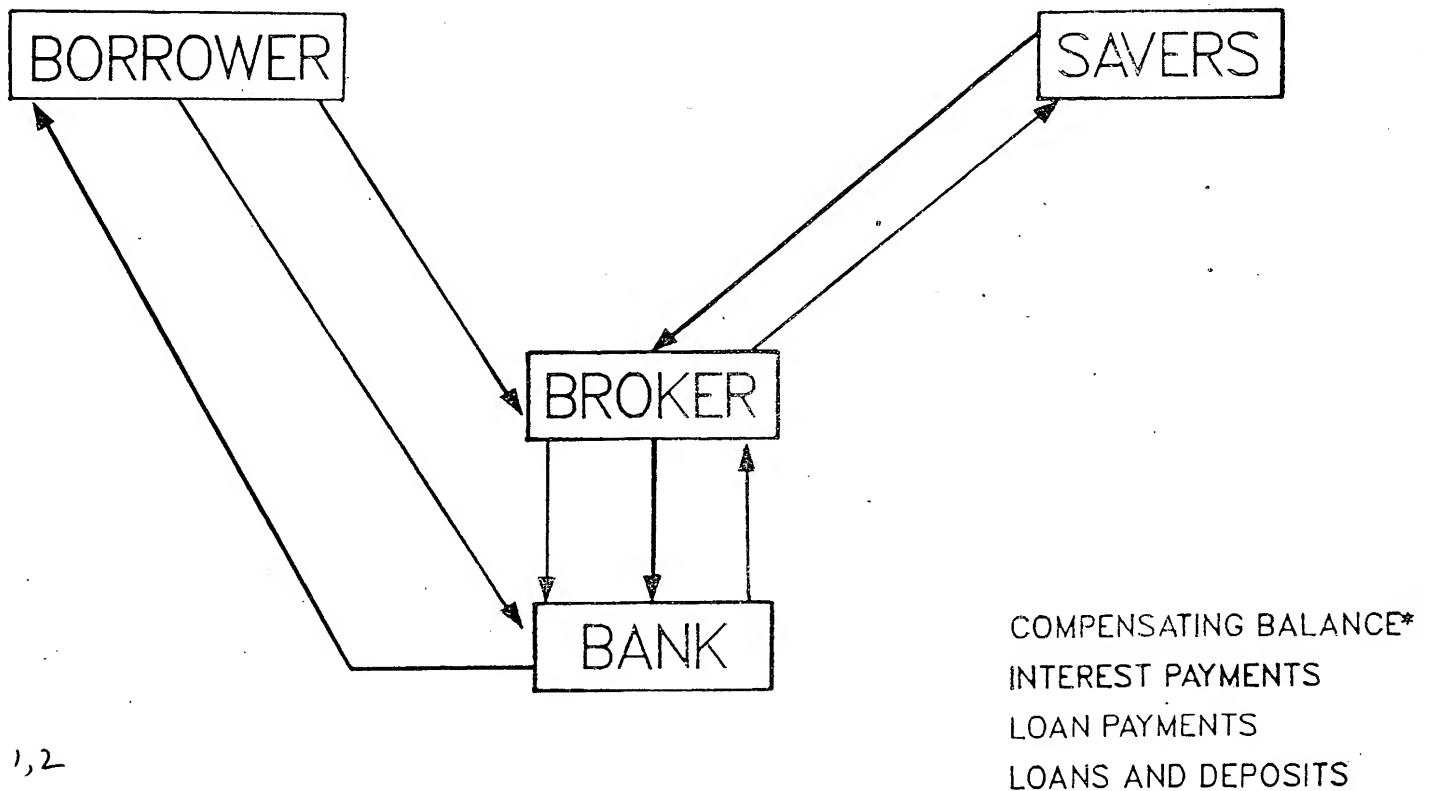
[REDACTED] The government has tolerated the curb market because it helps to ease the liquidity problems caused by its tight money policies, but major scandals are prompting a harder line. The recent liberalization of interest rates and laws discouraging the use of aliases which cloak curb market participants are moves intended to dry up these resources and bolster the formal financial sector.

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## Flow of Funds in the South Korean Curb Market



\* Compensating balances are loan funds left on deposit at a financial institution that raise the cost of borrowing by forcing a firm to borrow more than is necessary to simultaneously meet financing needs and the compensating balance.

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